constraints made it more difficult to do business, and limited the ability of businesses to grow.

As time passed, a new senator, Lindy B., saw another electoral opportunity…this time to make a Great Society! Lindy promised that if elected not only would he furnish the canoe navy with bigger spears, but he would also help the sagging economy by providing emergency unemployment fish notes to all laid-off workers.

His opponent, Buddy Goldfish, offered nothing but careful stewardship of the island's savings and boring protection for the islanders' economic liberties. More importantly, Buddy argued that the island could not afford such an extravagant "spears and fish" policy.

Not surprisingly, Lindy won in a landslide.

And so the process continued. Fish Reserve Notes were produced in ever greater numbers while the fishing fleet returned with fewer and fewer actual fish.

As official fish shrank to just one-tenth of their former size, even Ally Greenfin knew that he could not stretch the fish skin any further. When there were just bones left in the vault, he ran over to the Senate and called an emergency meeting.

TAKEAWAY

One of the reasons that economists have been so successful in obscuring the source of inflation is that they have short-circuited the very definition of the word. Nearly everyone believes that rising prices means inflation. So if prices aren't rising, there must be no inflation.

But rising prices are merely the results of inflation! The inflation is the expansion of the money supply.

Any dictionary printed before 1990 defines inflation purely as an expansion of the money supply. Newer editions have hedged their bets. But if you understand the true definition, you know that it is possible that prices can stay flat, or even fall, while the money supply itself is being inflated.

During a recession people wisely stop spending. When they do, demand drops and prices should fall. But sometimes these forces are counterbalanced by an expanding money supply that diminishes the value of currency. When inflation is present in a recession, prices may go up (if the printing is fast

enough), stay flat, or fall less than they would have with no inflation.

But during a recession prices need to fall in order to rebalance the economy. Recessions should be deflationary. Falling prices will cushion the blow of low employment. Somehow, modern economists see falling prices as a never-ending abyss toward demand destruction. They forget that when prices fall far enough, people start spending again. The process allows unneeded inventories to be worked off, and for prices to fall to a level justified by underlying supply and demand.

By keeping prices artificially high, inflation prevents this from happening.

CHAPTER 11

A LIFELINE FROM AFAR

When the senators convened, Greenfin told them that there was nothing more he could do: the bank was simply out of fish. Some senators suggested that they tell the truth to the islanders. Those proposals died in committee. Lindy searched for better answers.

He asked the island's brilliant economist Ben Barnacle to take over at the bank.

"No problem, sir," said Barnacle. "The situation is that the citizens are losing confidence. If we can start spending more of our Fish Reserve Notes now, that will restore confidence and then the citizens will start spending again. If I have to, I'll drop the Fish Reserve Notes from palm trees."

Some of the senators were a bit confused. Although none of them had Barnacle's economic training, some had the feeling that the problems stemmed from spending too much to begin with. Buddy Goldfish tried to talk some sense, but no one would listen.

Fortunately, the tough choices were avoided by a neat twist of fate.

Suddenly, the Senate door was flung open and one of the island's far-flung ambassadors, barged into the chamber with some very strange-looking people.

The ambassador had discovered an island across the eastern sea called Sinopia, where all the citizens still fished entirely by hand. Lacking the benefits of a free and developed economy, Sinopia struggled under the autocratic rule of an all-powerful king, who had subjected his people to whimsical experiments in social structure.

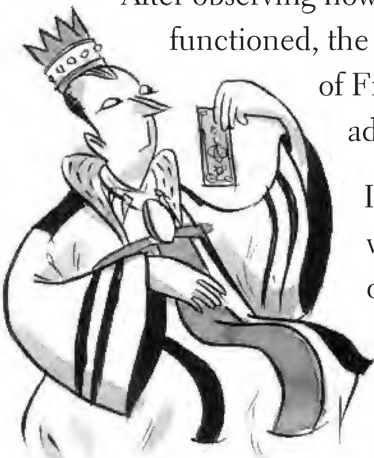
In Sinopia, all citizens were required to fish, but their catch did not belong to them. Instead fish were turned over to the king, who then decided which subjects deserved to get some back.

When the Sinopian king noticed that the diligence of some of the fishermen began to lag, he decided to require them all to sing together patriotically while they fished. Those who forgot the words, or hit a sour note, would not be fed until they learned how to carry the tune.

Although this system did not produce much fish per capita, those in control did take a very significant portion of what was caught. So while the king and his court dined on ocean delicacies, the average Sinopian got by on half of a fish per day.

Much like Usonia before the first development of capital, Sinopia had no savings, no bank, no credit, and no business. From the Usonian perspective, the Sinopian economy was still stuck in the dark ages.

To his credit, the Sinopian king was savvy enough to realize that his island was going nowhere fast. Upon hearing the tales of Usonia, the king was impressed by the luxurious lifestyle of its citizens, as well as the island's advanced system of banking, credit, and commerce. He was determined to bring the same level of prosperity to his island.



After observing how the oceanwide economy functioned, the king surmised that possession of Fish Reserve Notes was the key to advancement.

Indeed, he was aware that the notes were used as money across the entire ocean. The Bongobians accepted Fish Reserve Notes as payment for their bongos, and the Dervishers took them in exchange for their coconut oil products.

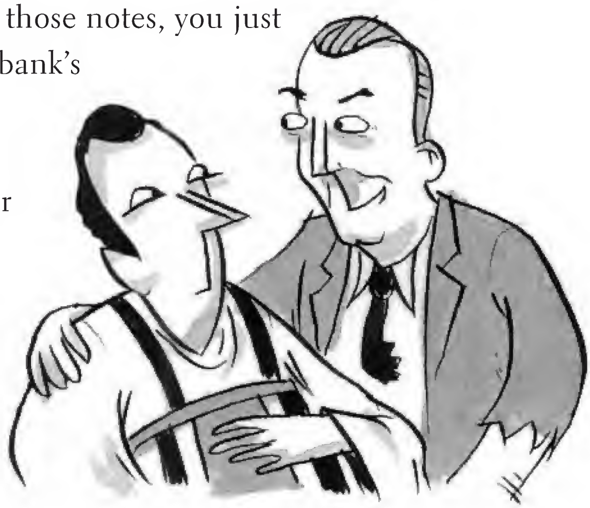
Sensing that the possession of the notes would allow his island greater access to the transoceanic economy, the Sinopian ambassador offered to exchange fish caught by his citizens for Fish Reserve Notes.

The senators looked at the Sinopians in disbelief. Then they looked at each other in giddy wonder. Could it be so easy? Access to fresh fish…in exchange for pieces of paper?

Without hesitation, Lindy B. stepped forward and agreed to their terms. Usonia would generously open the island's markets to Sinopian fish imports…and by the way, when could they start unloading the fish?

But before they drew up the paperwork, the Sinopian ambassador asked for reassurance that Fish Reserve Notes would always have real value.

"No worries," said Lindy B. "Anytime you want real fish for those notes, you just mosey up to our bank's fish window and we'll be happy to give you whatever you need. Just take a look around…does it look like we're short of fish?"



The treaty was signed and the Sinopian fish were delivered. In exchange, Lindy handed over a couple of stacks of freshly printed notes. Barely containing a chuckle he offered some parting advice, "Be careful with these, fellas. These things are very hard to come by."

Turning to the head banker, he said, "Hey Barnacle, let's get these fish over to the bank before we open for business."

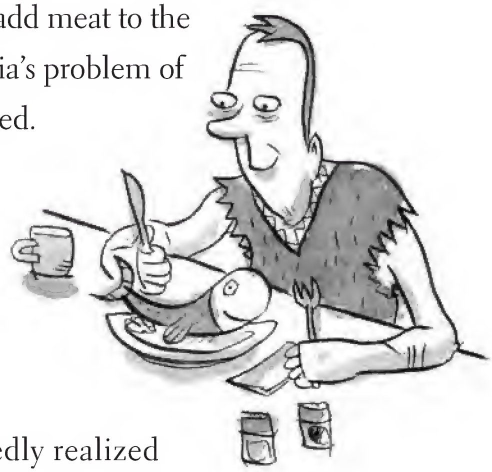
The relieved bank president needed no convincing. "No problem, sir. I've got a team of fish technicians waiting in the vault. They're ready to slice and dice these babies as soon as they arrive. All the depositors will get their fish today. And unlike yesterday, there will be plenty of meat on the bones!"

And so a new chapter in Usonia's economic history was born. Every day brought a new cargo canoe from Sinopia to make a deposit of fish, and every day the Sinopians got a new pile of Fish Reserve Notes in exchange.

The major question for the Sinopians was what to do with all the notes. The best thing would be to trade them for goods made by the Usonians. Of course, the Sinopians needed nets to increase their fishing efficiency, and Usonian manufacturers made the best nets in the ocean. So, the Able Net Company landed a massive order.

After all their buying, the Sinopians had some Fish Reserve Notes left over. Given the lack of a banking system in their home island, they decided to leave this trade surplus on deposit at the Fish Reserve Bank, where it would at least earn some interest.

The transactions were a huge boom to Usonia. Not only did the foreign demand boost the local economy, but deposits of Sinopian fish at the bank swelled the availability of credit. Even though the Usonians were spending more than they saved, there was still plenty of fish available to lend at low rates of interest.



With plenty of real fish to add meat to the bones of official fish, Usonia's problem of fishlation largely disappeared. With plumper fish, prices stopped rising and living standards rose once again.

In Sinopia things changed rapidly as well.

The Sinopian king belatedly realized the fatal flaw in his domestic economic model. His islanders simply would not fish if they had to give up all that they caught. Knowing this, the king made a dramatic reversal in policy when the nets came in from Usonia. Those who purchased nets from the king could keep all the extra fish they caught. Not surprisingly, this resulted in an increase in the Sinopians' daily fishing activities.

But there was a hitch—in order to facilitate greater trans-island trade, the king required his citizens to swap their extra fish for Fish Reserve Notes.

With personal incentives finally in place, it didn't take long for the Sinopians to accumulate savings and expand production. As a result, Sinopian entrepreneurs were now able to build factories to make other goods, like spoons and bowls. And even though most Sinopians still lacked these things, they sold these goods back to Usonians, for, you guessed it, more Fish Reserve Notes.

TAKEAWAY

For years, economists have mischaracterized the relationship between the United States and China. Most see it as a mutually beneficial system whereby the United States gets cheap products and cheap loans, and China gets manufacturing jobs. But is such an arrangement really a benefit for both parties?

The Americans do well: they get stuff without producing it and they get to borrow money without having to save. For their part, the Chinese get to work without consuming what they produce.

They save, but they don't get to borrow. Where's the benefit there?

Most contemporary economic pundits also fail to appreciate the degree to which low interest rates in the United States are made possible by high savings rates abroad. Remember, in order to lend, someone has to save. Fortunately for the United States, the global economy allows these relationships to go beyond borders.

The trump card for the United States thus far has been the status of the U.S. dollar. As the world's official *reserve*, the dollar is accepted as the exchange currency for any international transaction. This means that everyone, not just the United States and its trading partners, needs dollars to conduct trade. So even if no one actually buys things that are made in this country, dollars are always in demand. No other country has this monetary good fortune.

Many of these dollars held by foreigners are typically deposited in American banks, where they can be borrowed by Americans. That way we can spend even if we don't save.

By holding their currency to a strict peg against the U.S. dollar, the Chinese authorities have essentially required that their citizens hold at least some of their savings in U.S. dollars.

Without these savings from China and other nations, everyone in the United States including the government would have a much more difficult time borrowing, and they would likely have to pay much higher interest rates for the privilege. High interest rates and scarce credit would be a lethal combination for our debt-fueled economy.

As current American leaders come into increasing conflict with China, this lifeline needs to be clearly understood, before it is callously cast adrift. Of course, since this relationship cannot last forever, the sooner it ends the less painful it will be, particularly for Americans. The longer you eat for free, the harder it is to feed yourself when the free food stops coming.

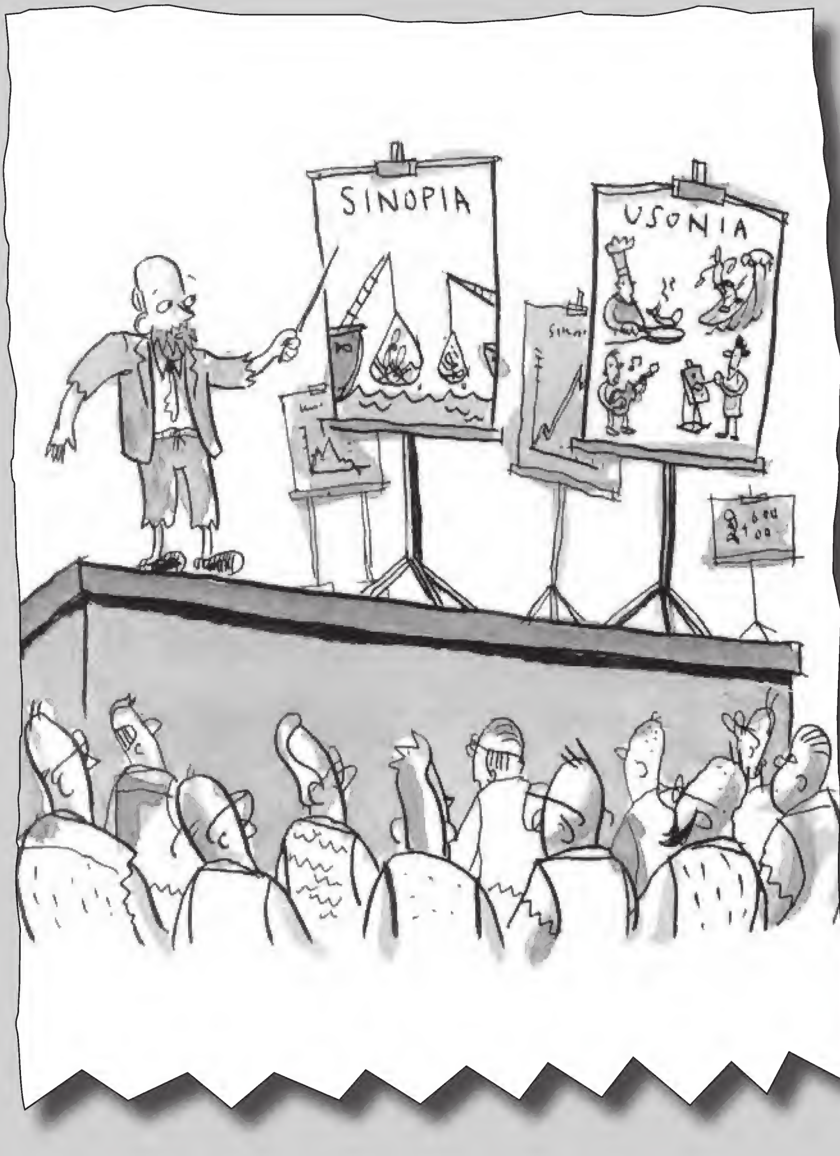
CHAPTER

12

THE SERVICE SECTOR STEPS UP

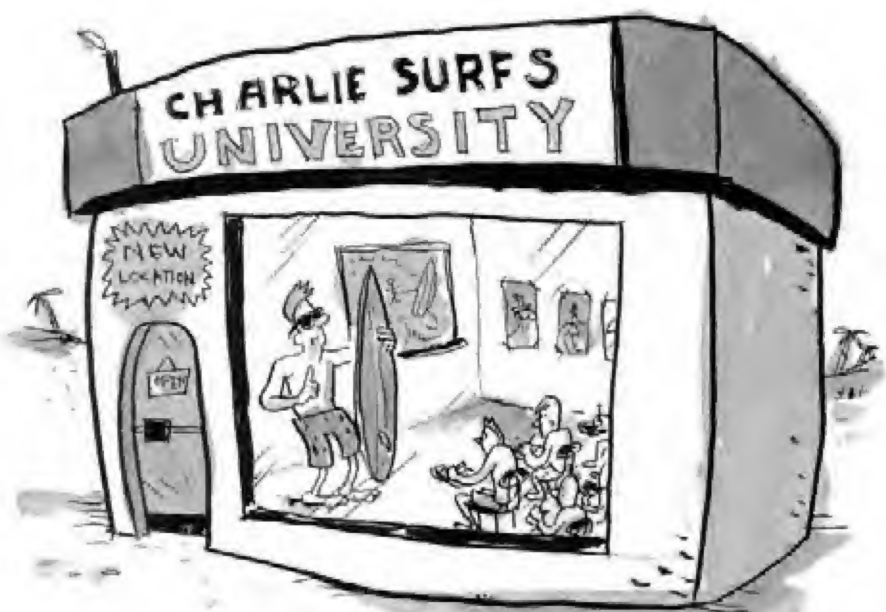
With the influx of Sinopian savings pushing down interest rates, Usonian entrepreneurs descended on bank loan officers with their best business ideas. But as the jobs of fishing and producing became increasingly outsourced to the Sinopians, the business plans they presented were very different from what the bank had seen in prior generations. Most business proposals now favored companies that required local workers to deliver a service. These jobs could not be outsourced and were generally less capital intensive.

In a celebrated oration given at the island's first economic conference, Ben Barnacle explained the changes. He argued that the Usonian economy had developed to the point where the lowly process of fishing and production could be relegated to poorer economies, leaving Usonians free to pursue more sophisticated "service sector" jobs like chefs, storytellers, tattoo artists, and the like.


SINOPIA
USONIA

Evidence of this change could be seen at Charlie Surfs, the venerable surfboard shop established by one of the island's founders.

After generations of manufacturing success, the company was moving in a new direction. Charlie's descendants landed a big loan to vastly expand their surfing school operations. Twelve new gleaming campuses were built across the island.



At the same time, the company struck a deal to manufacture its boards in Sinopia, paying off the foreign workers with Fish Reserve Notes, The higher-value activities of surfboard design and surfing instruction remained at home.

Soon more service sector businesses began to take root. The manufacturing facilities that had once populated the island began to be replaced by retail operations that sold goods primarily made on other islands.

The outsourcing trend was accelerated by various regulations, fees and taxes imposed by the Senate to make businesses cater to voters concerns. These obstacles made it harder for Usonian businesses to compete in the new trans-ocean economy.

Meanwhile, across the ocean, Sinopia was being transformed as well....

As expected, the imported net technology, combined with the energizing power of self-interest, caused fishing productivity to soar. Eventually Sinopians saved enough to build numerous mega-fish catchers of their own (the copyright infringement lawsuit brought by the original designers went nowhere in the Sinopian courts). They implemented a 24-hour fishing policy, with three shifts cranking out fish nonstop. A good portion of these fish were exported to Usonia.

As fish production became more efficient, workers were freed up for other tasks, most notably, manufacturing. Since the king's policy involved the accumulation of Fish Reserve Notes, he mandated that most of this new capacity be devoted to products that could be exported.

As canoe load after canoe load of fish and goods headed across the sea to Usonia, a flood of Fish Reserve Notes headed in the opposite direction.

In a typical trade relationship (like the one between Bongobia and Dervishia), Sinopian goods would have been exchanged for Usonian goods that were in demand back in Sinopia. But the Sinopian willingness to accumulate notes produced a completely different relationship in which one island largely produced and the other consumed.

Why the Sinopian king would tolerate such an arrangement puzzled many. But in comparison to some of his earlier schemes, this one seemed downright logical. The policy kept the king firmly in control, but it was hardly a boon to the

Sinopians who made surfboards but were too busy working to ever surf themselves.

Of course, the Sinopians believed that their ultimate reward would come in the future, when they could stop fishing and live off their savings of Fish Reserve Notes. Little did they realize that Usonia lacked the fishing capacity to feed its own citizens, let alone make good on all its outstanding notes.

At another island economic conference, Ben Barnacle claimed that this system represented the newest and most efficient example of economic specialization.

✔ REALITY CHECK

Like most economists of his generation, Barnacle saw consumption as the elusive driving force of growth. The biggest consumers were therefore considered the engines of growth.

But shopping in a mall is much more pleasurable than working in a mill. Anyone with half a brain knows that.

He explained that Usonia had a comparative advantage in consuming, and that this capacity was a great benefit to the entire ocean. No other island, he argued, had citizens of such voracious appetites, who could always be relied on to demand more. Usonians' wide roads, big carts, and big huts made them the most efficient consumers!

The optimistic, can-do spirit of Usonia also meant that its citizens never feared to spend…even when they didn't have two guppies to rub together. As a result, other islands could efficiently outsource consumption to Usonia!

On the flip side, Barnacle explained that the Sinopians were considered the best at generating savings and manufacturing products. Therefore, he argued, "It is simply more efficient to outsource production to Sinopia."

TAKEAWAY

Over the past decade, the problem of global imbalances has been a perennial topic at all the most important economic events. But despite the speeches and the acres of newsprint devoted to the topic, there has been absolutely no progress made toward resolving the problem.

The most visible statistic that charts the phenomenon is the U.S. trade deficit. For most of our history the United States exported much more than it imported, resulting in trade surpluses. In some years, especially toward the middle of the twentieth century, these surpluses were truly massive. We used the excess funds to build more capital at home, and to buy up more capital abroad. In the process we became the richest country on the planet. But in the late 1960s the trade balance started to change, and by 1976 the United States began running persistent trade deficits.

The dollar's reserve status has played a significant role in allowing this deficit to grow unchecked. Without the built-in demand for dollars made possible by the global economic system, no country could long sustain such imbalances. Companies and governments would simply refuse to trade goods for a currency with which it couldn't buy anything.

During the 1970s and 1980s these deficits were on the magnitude of $10 billion to $50 billion per year—large, but manageable. In the 1990s, the figures started hitting

the $100 billion mark. Although the extras digits were alarming, the gap was still relatively small in comparison to our massive economy. But with the new millennium, things started to get silly.

For the first decade of the twenty-first century, which corresponded with the rise of China as an export economy, the U.S. trade deficit averaged around $600 billion per year, topping out at a staggering $763 billion in 2006. That's more than $2,500 for every man, woman, and child in the United States.

After the recession of 2008 began, those figures mercifully started to retreat. But as we will see, U.S. policies soon put an end to that positive reversal.

Normally, trade deficits tend to be self-correcting.

A country with a trade surplus, in that it sells more abroad than it buys, will create an international demand for its currency. If you want its stuff, you need its currency. As a result, strong trading positions tend to strengthen a country's currency. The opposite is true with countries with weak trading positions. If no one wants your stuff, no one really needs your currency.

But when a country's currency rises, its products become more expensive. This gives a competitive opportunity to countries with weak currencies to start selling some of their products into that market. When they sell more, demand for their currencies rises. This currency counterweight should keep runaway trade imbalances in check.

But the dollar's reserve status, and the decision of the Chinese government to maintain the currency peg, has gummed up the machinery and has allowed the situation to grow dangerously out of kilter.

CHAPTER 13

CLOSING THE FISH WINDOW

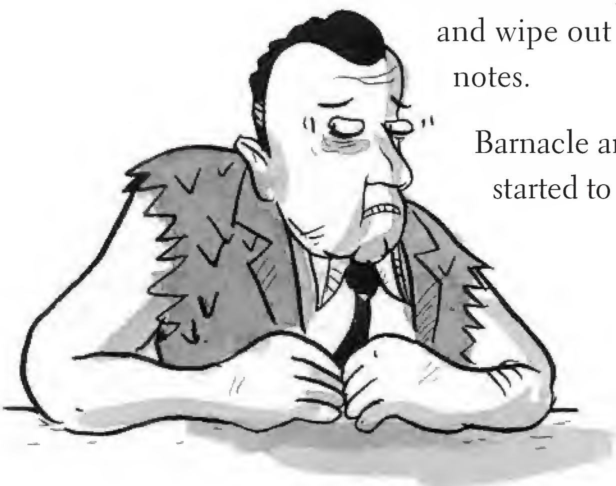
Eventually, as Fish Reserve Notes continued to pour out of Usonia and pile up on islands throughout the ocean, some foreign holders began questioning the ability of Usonia to redeem them with actual fish.

Chuck DeBongo, the charismatic leader of the Bongobians, gained favor at home by deriding the arrogance and power of Usonia. Believing that the acceptance of Fish Reserve Notes was unnecessarily enhancing Usonia's economic power, he started to send more and more of his financial agents to the bank's fish window to exchange his notes for real fish.

When those withdrawals started to make a real impact on the fish reserves, the technicians had to get busy again. As they sliced and diced, official fish once again became noticeably smaller, causing fishflation to rear its slimy head.

Consequently, the island's economy deteriorated once again.

The new Senator-in-Chief, Slippery Dickson, was told by his economic advisors that if other islands followed the Bongobians' lead, an oceanwide run on the Fish Reserve Bank could empty the vault of fish and wipe out the value of the notes.



Barnacle and the senators started to worry.

Lacking the spine to ask for tough choices from his citizens, Slippie (as he was known), decided to pin the losses on foreigners. He took the bold step of closing the bank's fish window to foreign depositors! From now on, the value of Fish Reserve Notes on the international market would be determined only by what someone was prepared to trade for them, not because they could be redeemed for fish. In truth, the notes' value would hang on Usonia's status as a great economic and military power.

The breaking of the "fish standard" caused many islands around the ocean to lose confidence in the notes. Not surprisingly, their value dropped sharply. But as they were still the most common form of money across the ocean, the fall eventually stabilized. Fortunately for the Usonian Senate, the closing of the fish window allowed the currency crisis to pass without bringing on a regime-changing catastrophe (the only real danger as far as the senators were concerned). Slippie breathed a sigh of relief.

Chuck DeBongo fumed and made threatening speeches. But his efforts proved largely symbolic—Usonia's power was unassailable.

Unfortunately, Slippie himself was later brought down by the subsequent Watersnake Scandal, in which he was caught with a large cache of stolen reptiles.

With the currency crisis in the past, fishflation largely under wraps, and Fish Reserve Notes maintaining their status despite the closing of the fish window,

the Usonian economy settled down. A few years later, a boost toward prosperity was provided by the election of Roughy Redfish to Senator-in-Chief.

Roughy succeeded in lowering taxes, rolling back some burdensome regulations, and reducing barriers to free trade with other islands. However, he failed in his promise to

reduce government spending. Despite the favorable business climate he instilled, the difference between what the Senate spent and what it raised in taxes continued to grow. In fact, under Roughy's watch, the gap widened dangerously.

Fortunately, fresh fish from foreign sources continued to roll into the bank. The notes that were used to pay for these fish were exported and never redeemed for actual fish. With such a favorable dynamic in place, Usonia set sail into what appeared to be an era of unprecedented prosperity.

TAKEAWAY

From the beginning of recorded history, humanity has used all sorts of things as money. Salt, shells, beads, livestock—all had their day. But over time metals, particularly gold and silver, have emerged as the most widely used forms of money. This is not an accident. Precious metals have all the qualities that make money valuable and useful: scarcity, desirability, uniformity, durability, and malleability.

Even if people didn't want the metal as money, it still had value based on its other uses and relative scarcity.

In contrast, paper money has value only as long as enough people agree to take it in exchange for goods and services. But that makes its value completely subjective. Since it can be produced at will, and has no intrinsic value itself, the paper can become worthless if enough people lose faith in it.

Although economists talk like they have seen it all before, the truth is humanity simply has no long-term precedent for universal economic activity based on irredeemable paper money.

History can show us many episodes in which individual governments, out of fiscal desperation, hitched their wagons to worthless currencies. Those experiments always ended in grief, especially for the citizens of the offending country.

That's because it is impossible for one country to sustain a worthless currency while its neighbors continue to issue real money. Naturally, foreigners would refuse to take the worthless currency, and eventually a black market for real money would arise in the country itself.

But now we are in a "through the looking glass" world where, for the past 40 years, no country issues real money. This is the biggest monetary experiment ever conducted. No one knows how or when it will end. But rest assured, it will.

CHAPTER 14

THE HUT GLUT

Despite the success achieved by Charlie Surfs' switch to the service sector, bank loan officers remained somewhat leery about providing funds for risky service sector businesses. Looking for a safe bet, they soon cast their eyes at the island's sleepy hut loan market, which seemed to offer a good source of low-risk loans.

Up until that point, the hut market had never figured prominently into the overall economic picture. The huts themselves were typically modest affairs well suited to the islanders' tropical lifestyle. But with prosperity growing and interest rates low, demand for newer, bigger and better huts began to emerge.

Traditionally, islanders would save for years, and then pay for a hut up front in full with cold, hard fish. But over time, the bank started making hut loans to the island's more secure borrowers. These loans meant that borrowers did not have to defer their purchases and could buy huts whether or not their savings equaled the purchase price.

Although such lending did not expand the island's productive capacity, or increase the borrower's capacity to repay (as a business loan did), these loans did have good underlying security. That was because, unlike a loan made to an entrepreneur with an unproven business idea, a hut loan came with a piece of solid collateral attached…the hut itself. If the borrower couldn't pay back the loan, the bank would take possession of the hut, which it could resell to pay off the loan.

Even with this collateral, there was no guarantee that the bank could get all its money back after such a sale. As a result of this risk, the bank demanded that borrowers come up with a substantial amount of fish for a down payment. This commitment would provide the bank with some assurance that the buyer would continue to pay. It would also limit the bank's losses if the borrower couldn't pay back the entire loan.

Some islanders resented the fact that access to hut loans was unequal. The wealthy usually got loans easily, but those who had no savings or poor credit had a much harder time. Some felt that the poor were being denied access to the island's upper echelons of wealth. Sensing a potent campaign issue, the Senate got into the game to fix the problem.

Arguing that hut ownership lay at the very core of the Usonian Dream, Senator Cliff Cod devised a plan where the government would ensure that everyone could get a hut loan. Not only would the Senate mandate ultra-low interest rates with very low down payment requirements, but it would

stand behind the loans and pay the bank back if the borrower couldn't.

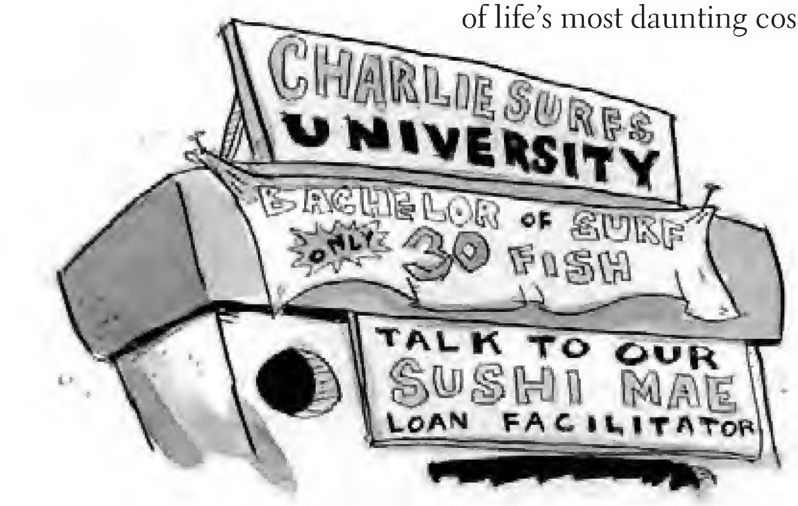
In order to facilitate the process, Cod created two agencies—Finnie Mae and Fishy Mac—to buy hut loans from the bank. The hut buyer would then pay back the agencies directly. The bank would immediately get back its principal, which it could use to make new loans (and be rewarded with a generous fee for its efforts). With the Senate guarantees in place, the bank dropped interest rates as it no longer needed the extra revenue to protect itself from losses due to defaulting loans.

The hut lending program was a huge hit with the bank, which was able to make nearly risk-free profits. It was also popular among voters, who no longer had to save half their lives to buy a hut. Based on his shrewd maneuvering, Cod was rewarded with a nearly lifetime Senate term.

Another agency, Sushi Mae, was devised to underwrite loans for youngsters wishing to enroll in surfing school. Guaranteed tuition loans on the table enticed more and more islanders to brush up on their cutbacks and nose riding.

With easy access to Sushi Mae loans, Charlie Surfs was able to raise tuition rates aggressively, without worrying about pricing its customers out of the market. Soon, tuitions began rising much faster than the overall rate of fishflation. Most economists assumed that the higher prices simply reflected the increasing social value of a surfing degree.

To keep pace with tuition increases, Sushi Mae continually increased the size of loans it was willing to guarantee. In a few years, surfing school tuition became one of life's most daunting costs.



Similarly, with Finnie and Fishy on the job, the island's hut building, hut selling, and hut decorating industries took off. These activities sucked up more and more of the island's productive energy, without doing much to bring in any more actual fish or increasing anyone's ability to repay hut loans.

✔ REALITY CHECK

Although these loan policies appeared to be a win-win for all involved, in truth, the system created great dangers. The Senate had distorted the credit market by imposing incentives that favored hut loans and education loans over other loans that had no guarantees. Loans were now being made not because they were necessarily the best use of savings, but because the senators had a political stake in encouraging hut ownership and education.

As interest rates for hut loans dropped due to the Finnie and Fishy guarantees, islanders were able to take out bigger loans. As a result, just like surfing school tuition, hut prices started moving noticeably higher. With steady price increases, islanders began to perceive hut ownership not just as an expense worth shouldering but as a vital investment. To guarantee a prosperous future, hut ownership was considered better than saving.

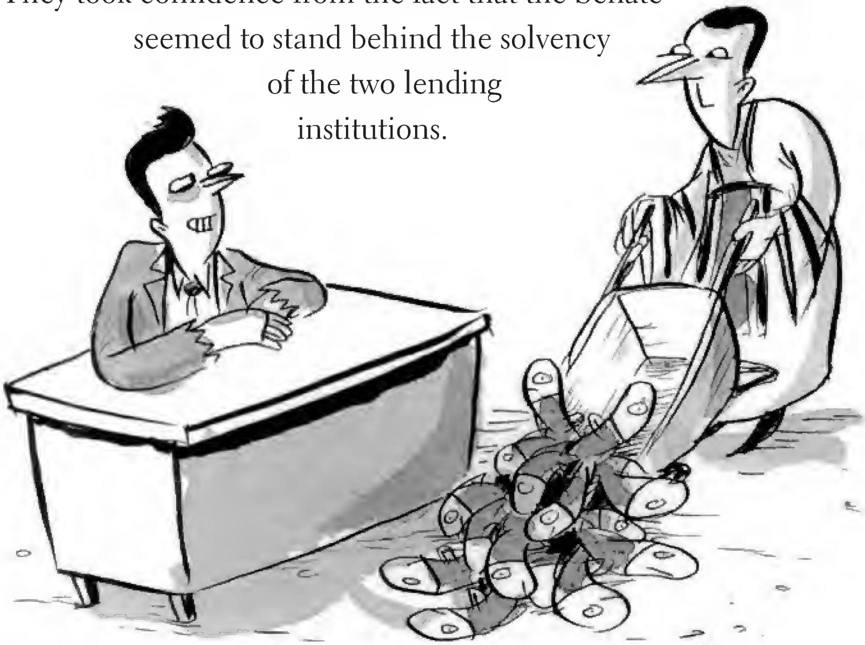
The Senate further stimulated the hut sector by declaring that profits made from buying and selling huts would be largely tax free, and that interest paid for hut loans could be deducted from the yearly fish tax. As a result, looking to buy and sell a hut for profit became a much more bankable financial plan than trying to start a business or saving for the future. Not surprisingly, the island got more new huts. But it also got less savings and fewer new businesses.

When the pace of hut price increases really gathered steam, loan amounts bumped into the limits that the Senate had placed on Finnie and Fishy loans. When that happened, Senator Cod inevitably stepped in, declared the fundamental soundness of both institutions, and urged the Senate to increase loan limits so that huts could remain affordable. He always prevailed.

The head honchos at Finnie and Fishy, both old friends of Cod, rewarded the senator's efforts with generous contributions to his reelection campaign and a sweetheart loan on his own hut.

Given that Finnie and Fishy paid a higher rate of interest to its investors than did the Fish Reserve Bank, the Sinopians piled some of their surplus fish notes into Finnie and Fishy.

They took confidence from the fact that the Senate seemed to stand behind the solvency of the two lending institutions.



The influx of Sinopian investment fish into the hut loan market swelled the availability of credit and brought down interest rates even further. This meant bigger loans became even more affordable. In turn, the ease of getting a big loan allowed buyers to throw caution into the wind and bid up hut prices even higher.

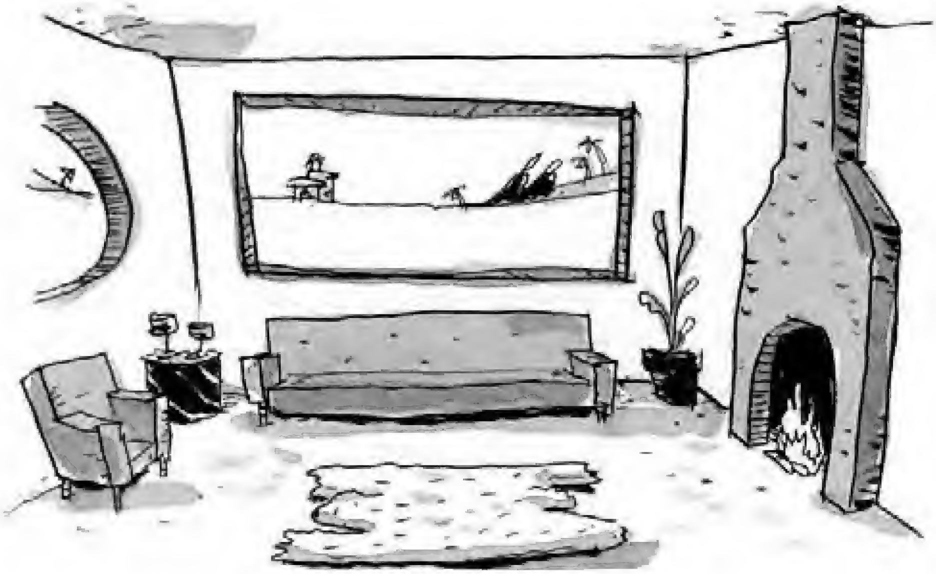
Sensing the profit potential, Manny Fund VII jumped into the market with both feet. The descendant of the island's first venture capitalist noticed that there were some loans that were so ridiculously risky that even Finnie and Fishy wouldn't touch them. But given the mania for hut investment, he believed he could rely on the old Manny Fund panache to convince buyers that the loans were solid.

Manny began offering islanders a new type of loan, which he called "hut fish extractions," in which hut owners replaced existing mortgages with bigger loans on the huts that they already owned. The new financing would pay back the original loan and put the extra fish into the borrower's pocket. The rise in hut prices justified the bigger loans. With Manny's "fish-traction" loans, anyone who owned a hut could get his hands on essentially free fish!

With the relatively high interest that Manny charged to fish-traction borrowers, his investment fund was able to offer even better yields to its investors. Not wanting to be left out of the party, Fishy and Finnie asked Cod to let them buy these riskier, higher-rate loans as well. When the approval came through, the two agencies became the biggest lenders in the fish-traction market.

Fish equity extractions provided a huge shot in the arm to the hut improvement industry, which became a major focus of economic activity. Hut Depot, an islandwide chain selling primarily imported hut improvement paraphernalia, employed dozens of specialists to show the islanders how to make more money through the magic of hut improvement. It was widely accepted that every fish spent on hut improvement would result in two fish in higher sales prices. No one was really sure why this was so…but why question the professionals?

Huts became much more luxurious than ever before. Fire pits were lined with polished abalone shells; water buckets were pulled aloft on the finest silk ropes. Many huts were fitted with designer thatchings and came with built-in wide-screen windows.



Soon islanders began demanding not just primary hut residences, but also investment and vacation huts. Some islanders even built vacation huts on top of their regular huts.

But then a strange thing happened. With all the demand for huts created by fish-traction loans, low (or no) down payment requirements, tax-free profit policies, and all the fish showered on borrowers by the bank as a result of the Finnie and Fishy guarantees, hut prices really started to go wild. Prices had always gone up a few percentage points every year, but now they were going up by that much every month! Bidding wars broke out for even the dumpiest huts.

Things got to the point where traditional measures of affordability no longer applied. It used to be that islanders would pay no more than two or three times their yearly

income for a hut. Now they were paying 10 or 20 times. People bought huts that they knew they could not afford in the belief that they could sell in a few years for far more than they paid. With that kind of profit potential, no downside risk, and oodles of government incentives including subsidized loans at artificially low interest rates, nobody could resist.

But the rapid rise in hut prices was a boon to the senators. The easy riches made voters feel wealthy and provided circumstantial evidence of wise economic leadership. Naturally the senators took every effort to keep the merry-go-round spinning. Ben Barnacle, and even the elaborately esteemed Ally Greenfin, assured all that there could be no such thing as a hut glut, because hut prices simply could not fall.

Not just politicians talked up the mania. The island's most respected private sector thinkers were the loudest cheerleaders. The dapper Barry Codroe had a popular stage show, where islanders discussed current events. The always optimistic Codroe dubbed the expansive era the "Goldfish Economy." Regular panelists like Carp Gaffer assured islanders that hard times were nowhere in sight and that bank policy had never been better. One occasional guest, Piker Skiff, often brought in for comic relief, warned of the pending hut collapse. His foreboding elicited howls of laughter.

TAKEAWAY

Now that it is painfully clear to everyone that the United States experienced the joy and pain of an inflating and collapsing housing bubble, we must take pains to remember that the vast majority of economists, government officials, and financial pundits could not see the calamity coming even as it stared them down at point-blank range.

It was as if all the meteorologists in the country failed to predict a category 5 hurricane when it was just 10 miles off the coast of Miami. Is there any more evidence needed to confirm the utter cluelessness of mainstream economic thinkers?

By any measure of sober valuation, home prices by 2006 had passed into Fantasyland. Valuations were disconnected from every gauge that had been designed to measure their affordability. None of the numbers added up. Yet somehow, economists came up with rationales that seemingly justified the ascent.

But people failed to see the agendas behind the cheerleading. Politicians wanted to keep voter confidence high through a sense of false prosperity; businesses wanted to keep consumers spending on products and services that they really couldn't afford; cable networks wanted to keep ratings high with optimistic hurrahs; and banks, mortgage originators, and real estate brokers wanted to continue making money on fees and interest. All of these interest groups had hired guns who put lipstick on the biggest, ugliest pig imaginable. And amazingly, their explanations were accepted.